Winter 1981-1982

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The Wharton Magazine

Whither The Office? Of Typewriters And Social History

A Legal Look At Performance Appraisal

Economics And The Koran: Banking Without Interest

Business In The World: Assessing Political Risk

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The Wharton Magazine Economic Newsletter

Econometric Forecast

For the United States, 1981.4 — 1984.3

Prepared by
Lawrence R. Klein, Donald Straszheim, Allen Gutheim, Edward A. Friedman, Stephen Able, Edward Hill, Wayne Tarken, Ellis Tallman, and Glenn Currier
Wharton Econometric Forecasting Associates

Rates Are Crucial To Recovery

The economy is well over the edge of the precipice and is gathering speed rapidly in its fall. Since last winter, when it bounced up sharply, the economy has flirted with recession. Under the providence of a tightening monetary policy, interest rates rose in the spring and remained high during the summer. Real growth faltered in the second quarter of the year, and the preliminary third quarter data indicated a second consecutive drop, although this was revised to a slight increase in the November release. During the spring and summer, the relevance of the "recession" description depended on what industry one was looking at, and, to some extent, in which part of the country one was located.

Tight money and the accompanying high real interest rates had an impact, but the effects were limited for the most part to the consumer interest-sensitive sectors – automobiles and housing. Demand for each virtually dried up during the summer.

Those who argued that the remainder of the economy could not endlessly resist the Federal Reserve's tight monetary policy turned out to be correct. By early autumn it had become apparent that economic growth was rolling over and heading down. By mid-autumn, it was clear that the economy was in a significant recession which would be deep, widespread, and would last into the winter.

We expect real gross national product to decline at an annual rate of 4.4% in the fourth quarter of 1981, followed by a drop of 3.1% in the first quarter of 1982. Growth should turn positive in the second quarter of 1982, but we do not expect any robust recovery to begin until the third quarter, when the next installment of the personal tax cut becomes effective.

For 1982 as a whole, real GNP is forecast to drop 0.4% after the increase of about 1.9% in 1981. In 1983 real growth is forecast at 4.1%.

The recession has sown the seeds of recovery in the form of substantially lower interest rates – despite the lack of any meaningful monetary policy turn towards accommodation. We expect that relatively low interest rates will increasingly aid home construction and sales and will help pull auto sales up in the months to come. By the time the large tax cut hits consumers in July, they should be ready to spend.

Perhaps the major uncertainty in the outlook is the behavior of interest rates as the recovery begins in earnest next summer. We have taken the Federal Reserve at its word – that money growth will be kept well in hand next year. Thus, while we have assumed that the Fed allows M1-B to accelerate somewhat in the coming months, we view this acceleration as little more than a technical response to criticism that the Fed has been overly tight in the past six months, precipitating the recession. On a quarterly basis, we project growth of M1-B to decelerate from the 6.5% range early in 1982 to the 5% range by mid-1983. In our view, easing inflationary expectations will cushion any further upward movement in interest rates. We forecast short-term rates to increase less than 200 basis points during the latter part of 1982 as the recovery gets under way. However, it may well be that monetary policy could be even tighter than we have projected, or that rates could move much higher than we have forecast even under our monetary view.

The outlook for inflation is brighter than it has been since 1978, prior to the last spurt in OPEC crude oil prices. Several factors contribute to this cheery picture.

First, we do not expect that food prices will aggravate inflation in any meaningful sense during 1982. We expect that the consumer price index for food will increase only 6.6% during 1982 – less than the 7.6% increase in 1981 and well below increases in the preceding three years, which were in the 8.6% to 11.1% range. Record harvests in the United States this year have stuffed storage facilities to overflowing, virtually eliminating the possibility of an acceleration of food price increases during 1982.

Second, crude oil prices, responding to slack economic growth, are expected to be unchanged during the year, before beginning a moderate increase in the range of 10% in 1983. With economic growth slow in Europe as well as the United States, only an extremely severe supply dislocation could upset this view.

Third, manufacturing cost pressures should be easing

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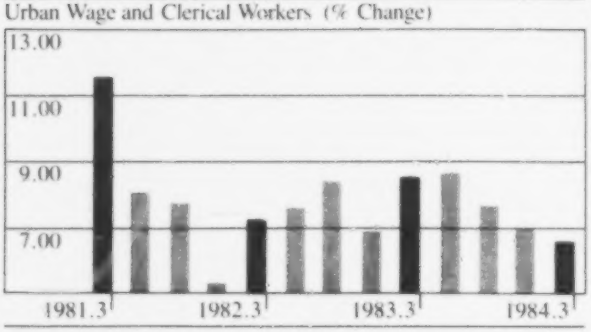
Consumer Price Index

Urban Wage and Clerical Workers (% Change)



during the year. As growth accelerates, a cyclical recovery in productivity will combine with a decelerating compensation growth rate to reduce the rise in unit labor costs. The prospect for a significant reduction in wage pressures in the coming years is good. Important labor bargaining will take place during 1982, with teamsters, auto workers, electrical workers, rubber workers, and other key unions coming up for contract renewal. With the economy struggling through the second recession in as many years, we believe that many of these contracts will be renewed with less aggressive compensation demands than in the last negotiation round. Capital costs will also increase less rapidly by virtue of the relatively low interest rates and the impact of the more favorable capital recovery provisions of the Reagan tax cut.

Finally, the dollar, while likely weakening vis-a-vis the currencies of our trading partners during the year, will remain above the relative levels of the past several years, and thus help to reduce the costs coming from the price of imported goods.

The unemployment rate is high, and will be moving higher before it peaks next spring. We anticipate that unemployment will move very close to 9% at its top. We then expect a slow decline during the remainder of the year, and in 1983.

Consumption

We expect the real recovery in durables to take place in mid-1982, fueled by the scheduled tax cut in July. Largely because of weakness during the first half of the year, unit auto sales in 1982 should recover only slightly from this year's performance of 8.6 million units to 8.8 million units. For 1983, however, we are more optimistic, since the combination of scrappage pressure and less expensive credit implies more robust growth. We expect new car sales will reach 10.4 million units in 1983.

Total real durable consumption is expected to show slow growth over 1982, being biased by the auto component and restrained by tight credit. A more accelerated growth pattern is expected for 1983. Growth should average 1.9% in 1982 and 10.2% in 1983.

As we are forecasting continued declines in consumption of gasoline, fuel oil, and coal through 1982, we expect almost no growth in total nondurable consumption, although clothing and shoe consumption should be stimulated by the tax cut in the third quarter. We predict that real nondurable consumption will increase by 0.8% and 2.8% in 1982 and 1983, respectively.

Foreign Trade

The recovery from the 1978-1979 second oil shock is slowly proceeding, but recessionary tendencies are proving unexpectedly persistent. The growth of global real output from 1981 to 1986 will be more sluggish than the period 1975-1979, which followed the first oil shock. Among the developed countries the brunt of this slow recovery will be borne by European nations. The United States and Japan will both perform relatively better than Europe in general – and better than West Germany in particular.

The prospects for the developing countries and the centrally planned economies in the next five years are hardly better than performance in the 1979-1981 period. Apart from the newly industrializing countries of East and Southeast Asia, the nonindustrialized world will continue to suffer from the feedback effects on trade and payments of the slow growth in the developed world. The centrally planned Comecon countries continue to suffer from their own longer-term supply-side problems of reduced availability or higher cost of energy resources and uncertain agricultural prospects. Slow growth in demand by the West for their exports, as well as high debt-service costs and debt-import ratios, will reduce their ability to import Western goods, especially capital goods, and inhibit their growth.

Easier U.S. monetary policy has combined with recession to lower U.S. interest rates, reduce capital inflows, and devalue the dollar to some extent. In turn, the rest of the OECD countries can now lower their interest rates. Three effects (lower dollar exchange rates, easier monetary conditions, and lagged positive effects of dollar strength on European net exports) will cause a significant easing of European balance of payments pressures. In this period the United States and Japan are in different cyclical phases from Europe, providing an element of stability for the total outlook. Unlike the nearly simultaneous slowdown and recovery following

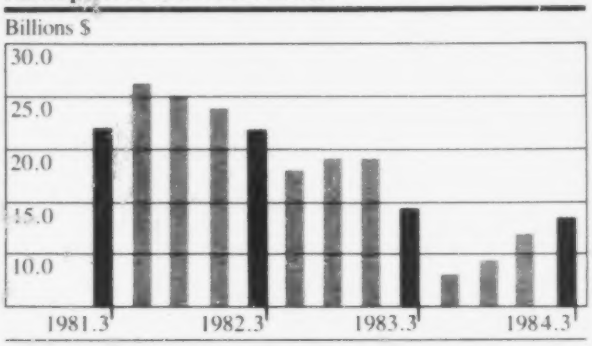
Forecast: The Next Two Years

Selected Major Economic Indicators—December 6, 1981

Item	1981.4	1982.1	1982.2	1982.3	1982.4	1983.1	1983.2	1983.3
Gross National Product $	2989.60	3027.90	3104.20	3199.00	3295.80	3389.20	3490.90	3599.20
% change	4.54	5.22	10.47	12.78	12.67	11.83	12.55	13.00
Real Gross National Product $ (1972)	1495.80	1483.90	1492.60	1509.80	1523.50	1535.90	1552.50	1571.70
% change	−4.42	−3.13	2.35	4.70	3.67	3.28	4.39	5.06
Implicit Price Deflator—GNP	199.90	204.00	208.00	211.90	216.30	220.70	224.90	229.00
% change	9.37	8.62	7.93	7.72	8.68	8.28	7.82	7.56
Unemployment Rate (%)	8.45	8.98	8.91	8.79	8.73	8.67	8.60	8.06

[$ amounts in billions, All $ figures are current dollars except those marked $(1972)]

Net Exports of Goods and Services



the first oil shock in 1973, the divergent growth (or decline) patterns around the world that are observed now can be traced to divergent national monetary-fiscal mixes.

The persistence of unemployment in Europe is clearly the major problem for the OECD area as a whole. The U.S. unemployment level is relatively flexible, with market conditions for labor adjusting to the excess supply of labor through downward adjustments of real wages, growth of the service sector, and migratory shifts of labor from areas of surplus to areas of deficit (for instance, from the industrial Northeast to the high-technology areas of the Sunbelt). The Europeans' problem is complicated by less flexible labor markets with respect to real wage adjustment, less opportunity to move, and the unfortunate coincidence of a demographic bulge in labor force growth (Europe's more modest "baby boom" lagged that of the United States by five to ten years).

In spite of the unemployment picture, there are some elements of good news in this outlook. The first is that, while remaining high relative to the decade of the 1960's, inflation should slowly moderate.

The other pieces of good news mainly support the better inflation picture. Real oil price increases out to mid-decade are likely to be modest, based upon reasonable estimates of world energy supply and demand. Further, the terms of trade between non-oil commodities and manufactured goods will probably not move much after 1982. There will be some increase of commodity versus manufactured goods prices in the near term, as restocking accompanies the slow business cycle recovery. Terms of trade stability, thereafter, will allow for more conscious planning, without discrimination in favor of or against countries which export or import these goods.

Real wage gains have lessened throughout the OECD – not simply in the United States, as is often noted for the decade of the 1970's. This, coupled with some apparently significant cyclical increases in productivity, will lower unit labor costs and contribute to the fight against inflation.

The asynchronous recoveries of the United States and the European economies do not bode well for the U.S. trade balance. With the U.S. recovery expected to begin in earnest in the second half of 1982, U.S. gross domestic output is forecast to increase by 4.0% in 1983. This rate is matched only by Japan. For the European economies, the growth rates that year are expected to be in the 3% range (except for West Germany, which is forecast to have a sluggish 2% rate of growth). This situation will lead to a rapid resurgence of U.S. imports unmatched by export growth, even allowing for a continued dollar weakness. The current forecast is for a continued deterioration in the U.S. current account balance.

Financial

The current weakness in loan volume is being paralleled by sluggish growth in the narrowly-defined money supply, M1-B. Fewer loans imply smaller deposit balances. But this has left M1-B below the lower end of the calendar 1981 target set for it by the Federal Open Market Committee (6.0% to 8.5% unadjusted, or 3.0% to 6.0% adjusted for shifts to NOW accounts).

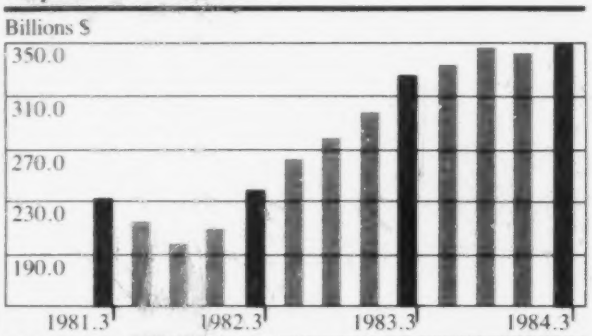
Since the declared long-run goal of the Fed is to reduce inflation via decelerated monetary growth, it would at first be thought that "going with the flow" and accepting unexpectedly low M1-B levels should delight the monetary policymakers. However, another Fed goal is stable, predictable monetary growth. That is, it appears that the Fed finds too low money growth as unacceptable as excessive growth. In the effort to hit its targets, the Fed has been aggressively pumping reserves into the system. These open market purchases, together with the weak economy, have been responsible for the falling short-term interest rates.

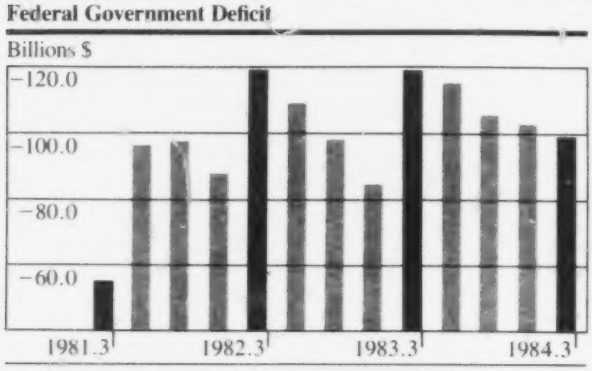
Our forecast is for rates to continue to fall slowly until mid-1982. This is mainly due to our expectation that the current recession will continue through the coming winter months. The stimulus to the economy in July 1982 of the 10% personal tax cut is expected to bring renewed real growth in GNP and, with it, renewed credit demands and the beginning of another upturn in interest rates. That upward movement is not forecast to be as sharp as those which occurred approximately between September 1979 and April 1980; between September 1980 and January 1981; and between April 1981 and July 1981. In each of those upturns, the prime rate touched or exceeded 20%. We expect the prime rate to drop to a trough of 10.8% in early 1982, and to peak at 12.8% in 1983.

We believe that two factors will combine to moderate the rise in interest rates. First, by next summer, the economy will have experienced five quarters of negative or negligible

1980	1981	1982	1983
2626.10	2921.30	3158.50	3550.70
8.79	11.24	8.12	12.42
1480.70	1508.90	1504.10	1565.90
−.16	1.91	−.32	4.11
177.40	193.60	209.90	226.70
8.98	9.16	8.43	7.98
7.15	7.63	8.81	8.37

Corporate Profits Before Tax





growth. Its weakness at that time suggests that there will be abundant slack in the credit markets, as there will be abundant slack in labor and product markets. Second, we have revised our forecast of M1-B growth upward for calendar 1982. We believe that the Fed will exceed the high end of its targeted 2.5% to 5.5% range, so that 1982 on a calendar basis will see growth of 6.4%. Subsequent growth in calendar 1983 is forecast to decelerate to 5.3%. Granted, the Fed has proven that it can hit annual M1-B targets in both calendar 1980 and 1981. It is also true that there has been no change in stated Fed policy. However, as the recession worsens and as unemployment edges toward 9%, monetary policy relaxation is expected in order to aid in the economic recovery. Further, the Fed may feel that if it has undershot for calendar 1981 it would not be inappropriate to overshoot for 1982 to balance things out.

Government

Despite congressional acceptance of the administration's tax and spending bills in July and the beginning of the fiscal "new year" on October 1, 1981, the budgetary process for fiscal 1982 has yet to be concluded. The administration's forecasts of the deficit have been revised upward since its budgetary package was developed, leading the president in September to propose even further spending cuts and some tax increases over fiscal 1982-1984.

For fiscal 1982, President Reagan proposed further reductions in nondefense appropriations of approximately $8.4 billion, entitlement reform aimed at generating $2.6 billion in reduced federal outlays, a $2 billion reduction in defense purchases, and tax code changes designed to produce additional revenues of $3 billion. For fiscal 1983 and 1984, he added an additional $25 billion in unspecified budget savings to the $75 billion in unspecified budget cuts already contained in the July budget. The bulk of these additional savings were to be in the form of increased taxes.

These proposals have not been received favorably by Congress. As a result, the president has reduced the size and composition of the further savings he would like to have incorporated into the fiscal 1982 budget. The proposed saving in nondefense spending has been reduced to $4 billion, and the proposed reductions in entitlements and increases in taxes have been eliminated from the revised budget amendment package for fiscal 1982. Congress continues to call for an even smaller reduction in nondefense spending and reductions in defense spending of more than President Reagan's proposed $2 billion. We assume that the outcome of the current impasse will be further reductions to the fiscal 1982 budget of $6.5 billion, approximately $2.5 billion of which will come out of nondefense purchases, and $4 billion of which will come out of defense. We also assume that the reductions which are realized in formulating the fiscal 1983 and fiscal 1984 budgets will be confined to those proposed in the July version of the administration's budgets.

Although the federal budget assumed in our forecast calls for very slow growth in nondefense purchases over the forecast period, averaging little more than 1% per year, and annual declines in grants-in-aid averaging approximately 4% per year, total federal spending is expected to grow by almost 8% per year during 1982-1984. This is due to the very large growth which is expected to occur in defense purchases (almost 19% per year) and in interest payments (more than 12% per year). Primarily because of the 10% personal tax rate reductions scheduled for July 1982 and July 1983, federal revenues are expected to grow by only 6% per year over the forecast period, resulting in a slowly expanding budget deficit. The federal deficit is expected to approximate $100 billion in each year of our economic forecast.

The outlook for state and local governments over the forecast period is not bright. The small budget surpluses recorded over the past few years are expected to dissolve during 1982-1984. As a result of the substantial reduction in federal grants-in-aid, growth in state and local revenues is expected to slow from an average annual rate of more than 9% during the 1976-1981 period to a rate of approximately 7.5% overall during the forecast period.

Employment, Wages & Prices

The unemployment rate is forecast to jump from 7.2% in the third quarter of 1981 to 8.5% in the fourth quarter, and further to 8.9% in the first quarter of 1982. Unemployment should post a yearly average of 8.8% for 1982, up 1.2% from the 1981 average. Total employment is expected to rise modestly throughout 1982, but a significant drop of 800,000 persons employed is in view for the first quarter.

Inflation is forecast to continue to subside over the forecast period, though this decline is not uniform. As measured by the implicit GNP deflator, which drops from a percent change rate of 9.4 in the third quarter of 1981 to a rate of under 7.7% in the third quarter of 1982, inflation maintains a trend of moderate deceleration through the end of 1983. The figure for percent change of the consumer price index shows even more promising signs for slowing inflation, with a decrease from 11.7% in the third quarter of 1981 to a low of 6.4% in the second quarter of 1982. These CPI figures are due in part to the assumption of diminishing mortgage interest costs.

Wage increases are expected to be moderate throughout the upcoming year, in spite of a number of large collective bargaining agreements slated for negotiation over the period. The weak state of the economy, with accompanying high unemployment, and increased pressures from foreign competitors in key industries should combine to temper labor's wage demands. The rate of increase of private compensation per manhour is forecast to decline

after the fourth quarter of 1981, reaching a low point at the end of 1982. This, plus rising productivity, implies improvement in unit labor costs, and ultimately suggests an improved inflation picture.

Investment

Housing

The financial squeeze of the last year continues to take its toll on the residential construction sector of the economy. However, the recent decline in interest rates promises that improved performance is not many months away.

The current inventory of unsold new homes represents a ten month supply. While this level of inventories is clearly excessive and costly for the builders, it does indicate that the dramatic slowdown in starts has now worked its way through to the completions figures, with current sales running ahead of completions. With little prospect of a significant change in the permits and starts numbers in the next one or two months, we expect the inventory of unsold homes to continue to decline slowly.

The recent declines in interest rates may have come too late to be of any help to the housing industry in 1981, but we should begin to see their effects during the first quarter of 1982. At the present time we expect total private housing starts to bottom out in the fourth quarter of 1981 at an annual rate of 831,000 units, which gives us an annual total of 1.09 million units for 1981. We expect 1982 to be a year of weak activity, but of steady growth for the housing industry.

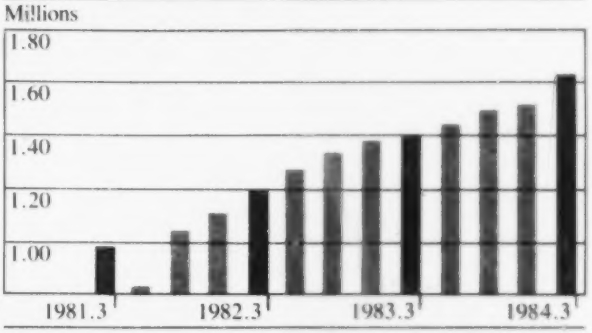
During the first quarter of 1982, starts should just exceed the 1 million unit annual rate. They should then climb to the 1.27 million unit rate by year-end, for an annual total of 1.17 million units. This slow growth in housing starts over 1982 translates into a 6.9% increase in total nominal residential investment, and a 0.6% decline in real residential investment.

At the present time we expect calendar year 1983 to be appreciably stronger than 1982 for housing. Total private housing starts should pass the 1.45 million unit annual rate by the end of 1983, and real residential investment should be about 14% higher than the end of 1982.

Nonresidential Investment

The general economic environment suggests further weakening in real nonresidential investment. Capital budgets for 1982 at most companies have been prepared with a sluggish economy and continued high long-term interest rates in mind. In addition, the stagnant economy has substantially reduced demand for investment, since capacity utilization has fallen and therefore has diminished the need for additional production capacity.

Private Housing Starts



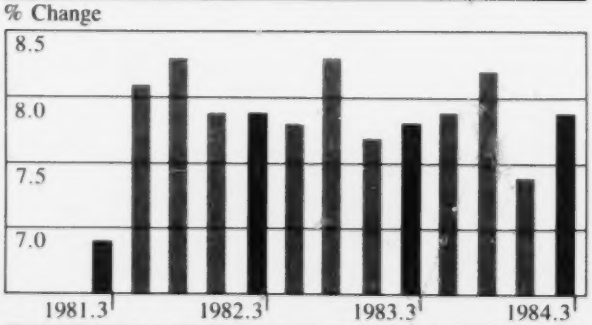
Recent nonresidential investment data depict a slow but consistent growth in structures since the recession in the second quarter of 1980. The present rate of real investment in structures exceeds the pre-1980 recession level. However, we do not foresee continued strong performance in structures investment. Partially completed structures tend to be completed despite a poor economic environment. We expect real investment in structures to show significant declines throughout 1982. The decline should end near the end of 1982, about a half year after the stimulus of the 1982 tax cut. The significant recovery in investment in structures should occur in 1983, when we forecast annual growth of 1.9%, with substantially stronger growth on a quarterly basis.

Investment in equipment grew at 11.8% at an annual rate in the first quarter of 1981, declined by 5.9% in the second, and declined again by 4.0% in the third. We expect real investment in equipment to decline sharply in the fourth quarter of 1981, by 9.2%, and to decline by 7.9% in the first quarter of 1982. We foresee a recovery in equipment investment taking place in mid-1982, since equipment expenditures require less financing and shorter planning schedules than structures. Equipment investment should show strong recovery in 1983 (5.1% in real terms).

Inventory accumulation during the present recession has been relatively mild as a result of cautious business behavior during the past two years. Businesses have been holding low inventory stocks because of the high cost of maintaining inventories with high interest rates as well as the current cash squeeze in most firms. In addition, business executives have feared recession in each of the past two quarters and have acted conservatively in order to avoid involuntary inventory accumulation.

Our forecast shows the peak in inventory accumulation occurring in the third quarter of 1981. However, the inventory swing is not nearly so volatile as in the 1973-1975 recession. The smaller inventory change from peak to trough in the present recession is a key difference in the smaller decline, but slower recovery, that we are predicting, in comparison to the 1973-1975 recession. ■

Private Compensation Per Manhour



Detailed forecasts of the U.S. and world economies are available on a fee basis from Wharton EFA. Enquiries should be directed to: Business Manager, Wharton EFA, 3624 Market Street, Philadelphia, PA 19104.

The Hay Report: Part 2

International Executive Compensation

Weak performances overseas gave American managers an edge in the salary sweepstakes. In France, the new government seems certain to raise taxes. In Mexico, compensation at multinationals has fallen behind the pace set by local firms.

This fifth annual report compares executive salaries in the United States with those in fourteen other major industrial countries. The Hay Group is an international management consulting organization with eighty-six offices in twenty-five countries, and clients in many more. The Hay survey data are used by companies around the world in establishing their pay practices. The authors of this report are C. Ian Sym-Smith, General Partner, and Mark S. White, Director of International Compensation.

The past year was not one of increased wealth for managers within the United States. Although salaries increased close to 10 percent, inflation hurtled along at the same rate, eating up the increase, even before we take into account the higher tax bracket in which managers found themselves. This is a poor beginning to make comparisons with pay levels for managers in other countries.

Nonetheless, there has been a dramatic upward change in the ranking of an American manager's pay package when compared with those of other countries. This is true on a pre-tax, and even more so on an after-tax, basis.

What has happened is that the U.S. dollar has had a very large increase in value against the currencies of many other countries. This underlines the importance of foreign currency exchange rates when making dollar equivalent comparisons and the volatility of such comparisons. The dollar rose against the currencies of all the countries in our sample, except for Australia and Venezuela, which held their own.

The result of this can be seen in the charts, which depict graphically the relationships of dollar equivalent base salary practices as of July 1981 among the same fifteen countries reported in prior years. Comparing these charts with the ones we have published in previous years, we can see that the gap between the higher paying countries and the United States has narrowed appreciably. Two countries having higher dollar equivalent salary practices during the past several years now fall below the United States. Another has moved ahead of American practice for the first time. This abrupt change is more clearly indicated in Table 1. There are some important points to keep in mind about the charts:

□ The scale along the bottom line indicates different levels of management as represented by Hay units of job content. (These units are explained in detail in the

Table 1: International Ranking of Executive Salaries, 1981

(Bold numbers are rank order.)

Middle Management, 600 Job Units	Base Salary in U.S. $(000)		% Change in U.S. $	% Change in Local Currency	% Increase in Inflation	% Change Exchange Rates
	1981	1980				
Switzerland	**(1)** 87.0	**(1)** 107.4	−19%	4%	6.5%	−22%
Belgium	**(2)** 75.4	**(2)** 105.1	−28	2	7.2	−29
Venezuela	**(3)** 74.5	**(7)** 64.1	16	16	28.5	-0-
Germany	**(4)** 74.3	**(3)** 94.4	−21	8	5.6	−27
Brazil	**(5)** 72.7	**(6)** 69.6	4	84	100.0	−43
Mexico	**(6)** 69.9	**(10)** 58.4	20	28	28.3	− 7
France	**(7)** 67.3	**(4)** 86.5	−22	9	12.0	−29
United States	**(8)** 64.6	**(9)** 58.9	10	10	9.6	—
Netherlands	**(9)** 60.0	**(5)** 81.8	−27	2	6.6	−28
Australia	**(10)** 54.8	**(12)** 51.6	6	7	8.8	− 1
Spain	**(11)** 51.4	**(8)** 59.8	−14	18	14.9	−27
Canada	**(12)** 50.3	**(13)** 48.2	4	9	12.5	− 4
Italy	**(13)** 48.7	**(11)** 56.6	−14	22	24.5	− 9
United Kingdom	**(14)** 42.2	**(14)** 48.2	−12	9	11.7	−20
New Zealand	**(15)** 33.3	**(15)** 33.5	− 0.6	15	18.9	−14

In Brazil, inflation was 100 percent, and managers got an 84 percent salary increase.

Fall 1981 issue of *The Wharton Magazine*, pages 54-55.)

☐ Although we are comparing base salaries, the relative picture would not be very different if we included bonuses. Only the ranking of the United States (and Canada to a lesser extent) would rise because the practice of paying bonuses is much more restricted in other countries, both as to amount and as to the number of people receiving them.

☐ For each country, we are reporting pay for nationals. Expatriates, a small minority, are excluded.

☐ In most countries in the survey, the companies are predominantly locally owned, but there is a substantial representation of multinational companies everywhere.

☐ The relationships shown here cover professional and management salary levels only. The relative ranking of blue collar workers from country to country can be very different.

Europe

The European currencies, assaulted by weaker economic conditions, high inflation, and political uncertainty, fell by 9 to 30 percent against the dollar, boosting correspondingly the comparative level of pay of the U.S. manager. The Italian lira fell the least at 9 percent, and the French and Belgian francs the most at 29 percent (see Table 1).

Not only have the rankings changed but the exchange rates have greatly compressed the differential in dollars between the salary practices of most European countries and those of the United States. To illustrate: Although Swiss managers retained their premier position, whereas last year they were paid a dollar equivalent salary 82 percent higher than a similar position in the United States, this year they are down to 35 percent higher. In Belgium the drop was from 78 percent greater to 17 percent greater; in Germany from 60 percent to 15 percent greater. The dollar equivalent salaries of executives in the Netherlands took them from fifth position (139 percent of the United States) to ninth (93 percent of the U.S.). Thus, Dutch managers now fall behind their American equivalents in the parade. Also dropping behind the United States is Spain, which passed from eighth position to eleventh. France, which now ranks just above the United States in the seventh position, fell there from the fourth level. Executives in the United Kingdom, who in 1980 were boosted by strong sterling to within 18 percent of their U.S. counterparts, have now sunk with the pound to 34 percent below, in the cellar just above New Zealand.

Western and Southern Hemispheres

Executives outside Europe have not fared so badly. This is because their currencies did not slip as badly against the dollar. Venezuela and Australia, whose currencies maintained pace with the dollar, moved ahead considerably – Venezuela from seventh to third position and Australia from twelfth to tenth. Canada, which saw only a modest further slippage in its dollar, overtook Italy. The only currencies from among this group of countries which saw a significant devaluation were the New Zealand dollar and the Brazilian cruzeiro. A New Zealand manager now gets paid little more than half of his U.S. counterpart's salary.

In Brazil, despite the huge loss in value of the cruzeiro, the Brazilian manager moved slightly ahead. In that country a substantial portion of a manager's income is indexed to inflation. Inflation was 100 percent, and managers got an 84 percent increase. This was ahead of devaluation and moved them up from sixth to fifth position in dollar terms.

Salary Increases and Inflation

As was noted above, salary increases in the United States just about matched the increase in the consumer price index. This was also the case in Mexico, and nearly so in Australia. For most of the other countries the situation was considerably worse, with the local CPI topping increases in pay by several percentage points. The exceptions to this general deterioration were Germany and Spain – where a slight increase in purchasing power was realized. The rate of inflation in the Netherlands and Belgium was close to that of Germany (6 to 7 percent), which is quite modest these days. There has

Table 2: After-Tax Income

(All figures in thousands of U.S. dollars. Bold numbers are rank order.)

Middle Management 600 Job Units	1981		% of Gross		1980		% of Gross	
Venezuela	**(1)**	$66.9	**(1)**	90%	**(3)**	$61.2[1]	**(1)**	90%
Switzerland	**(2)**	59.4	**(7)**	65	**(1)**	70.5	**(7)**	66
France	**(3)**	53.5	**(2)**	79	**(2)**	69.0[1]	**(2)**	79
United States	**(4)**	48.0	**(3)**	74	**(6)**	44.4	**(3)**	75
Germany	**(5)**	46.3	**(9)**	62	**(4)**	59.1	**(9)**	63
Brazil	**(6)**	44.7	**(10)**	61	**(13)**	31.2	**(10)**	62
Mexico	**(7)**	40.7	**(12)**	58	**(11)**	33.6	**(12)**	58
Belgium	**(8)**	37.4	**(15)**	50	**(5)**	50.8	**(15)**	48
Spain	**(9)**	36.9	**(4)**	72	**(7)**	44.0	**(4)**	74
Italy	**(10)**	34.4	**(6)**	71	**(9)**	40.6	**(6)**	72
Canada	**(11)**	32.9	**(7)**	65	**(14)**	30.9	**(8)**	64
Australia	**(12)**	32.9	**(11)**	60	**(12)**	31.5	**(11)**	61
Netherlands	**(13)**	31.7	**(14)**	53	**(8)**	41.9	**(14)**	51
United Kingdom	**(14)**	30.4	**(4)**	72	**(10)**	35.3[1]	**(5)**	73
New Zealand	**(15)**	19.0	**(13)**	55	**(15)**	18.8	**(13)**	56

[1]Reflects revised tax data.

been, however, what is in essence a freeze on salary increases in the Netherlands, which is why there was only a 2 percent year-to-year increase in local salaries. As a result, managers there, despite modest inflation, suffered a loss of purchasing power.

Mexico Moves Up

One country which ranked below the United States in 1980 now has its middle and upper managers paid at levels considerably above their counterparts in the United States. This is Mexico.

Several years ago this was also the case, but in August 1976 the peso came under considerable pressure and was allowed to float from the long-standing 12.5 pesos per dollar to twenty. The result is that for several years now Mexican pay has ranked on the lower half of the table, although gaining steadily each year.

In Mexico, in the last four years (1978-1981), the annual consumer price index increases have been at a rate in excess of 20 percent; the increase was nearly 30 percent last year. Petroleum exports and government control of imports, however, have contained the depreciation of the peso against the U.S. dollar to the current level of approximately twenty-five pesos per dollar. One could expect the high inflation rate in Mexico relative to the United States (approximately double) to result in a much more rapid depreciation of the peso. Since this has not happened, the large peso salary increases also got translated into large dollar increases. The result is that, for the reference level job, Mexican managers have moved up from tenth to sixth place over the past year. As the charts indicate, further up in the structure Mexican managers are even more highly paid. Conversely, at the bottom of the management hierarchy, the Mexican pay structure becomes the low line in the comparison.

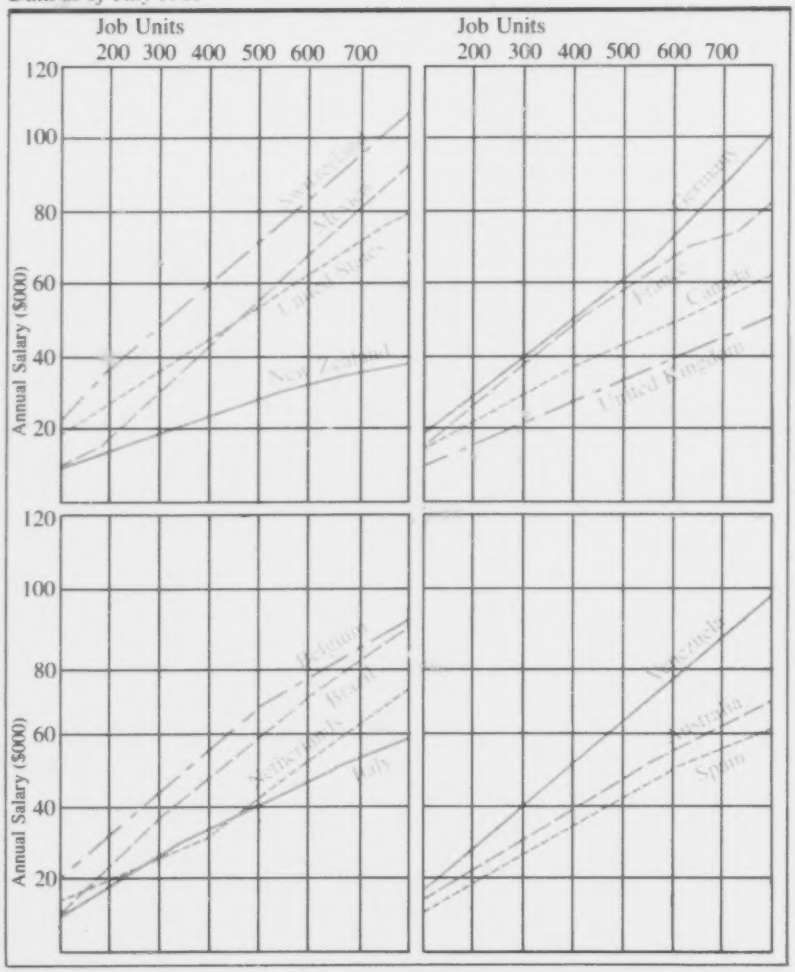
Given the real growth of the Mexican economy, boosted even further by the oil boom, inflation is likely to continue at the current level. In the boom conditions which exist, the shortage of management talent is likely to lead to continued increases in management salaries. Depreciation of the peso is also likely to increase over the next year. Nonetheless, one can expect Mexican managers to do better than their U.S. counterparts.

To do better means only in terms of dollar equivalent salaries. Although salaries have increased enormously, so has inflation. In Mexico, as elsewhere, spending power has deteriorated.

It is interesting to note that an unusual cleavage has opened up in salary practices for senior executives between foreign-controlled companies and Mexican controlled companies. The latter have responded to the boom conditions by increasing considerably the pay and perquisites for their senior management. Multinationals have been slow in doing so and now often pay well below their Mexican competitors, which adds a cautionary note to management on the use

1981 Base Salary in U.S. Dollars

Data as of July 1981



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The new American tax regulations will protect executives from bracket creep.

of intelligence such as provided in this article; it must understand the underlying forces in the particular country.

Taxation

The recipients of the income shown on Table 1 have to share significantly different proportions of it with their tax authorities. In Venezuela they get to keep 90 percent and pay the government 10 percent (see Table 2). Managers in Belgium and Holland share practically on a 50-50 basis with their governments. American managers rank third in the proportion that they are allowed to take home – 74 percent.

On an after-tax basis, Americans rank fourth in their dollar income, up from sixth last year. It is not that their tax rate has gone down (in fact, inflation moved them into a slightly higher tax bracket, and they are now paying 1 percent more). What has happened is that others are earning less in dollar terms because of the exchange rates.

The French incumbents of the reference level job, although dropping from fourth to seventh position on a gross salary basis, slipped back only one level on an after-tax basis because they had the second highest ratio of after-tax income, 79 percent. Their days are numbered. The Mitterrand government is materially changing the existing tax regulations, and the ranking of French executives on this table will drop several steps when we look at it next year.

The crystal ball has better news for American executives. They have moved up this year because of the favorable exchange rates, and with the new U.S. income tax regulations they will be protected from the tax bracket creep which continued inflation had subjected them to. They are thus likely to find themselves in third place next year.

Purchasing Power

Companies operating in only one country have the concern that their managers be paid at appropriate competitive levels relative to all other managers (including multinational managers) in similar positions in that country.

They look periodically at data basically similar to that shown in Table 1 to make fundamental decisions on levels of base salary, and in Table 2 to see the need for packaging cash and non-cash compensation in such a way that it attracts a minimum of taxes.

As long as executives remain in their own country, these are the basic concerns of their employers (whether national or multinational). The moment the company wants to move an executive to another country, however, it has a very different concern from a total remuneration point of view, because the executive will want to maintain his or her standard of living. The data in Table 2 rank the dollar-equivalent take-home pay of executives in similar jobs in a particular country. These numbers do not tell the purchasing power of that net income – that is, how much can be bought with that particular amount of money.

The data tell us, for example, that 600-job-unit executives in Switzerland take home nearly twice as much as their Canadian counterparts, both having paid their taxes. Does this mean that one has twice the purchasing power of the other? No. The cost of living varies considerably from one country to another. If the food, consumer goods, health services, and housing are similar and as plentiful and cost the same as the executive had in his or her old country, then there would not be any burden. But what's available can be quite different in another country; and the cost can vary widely.

For a multinational organization to make decisions in this area, it needs reliable and current information as to local pay practices and trends, inflation rates, exchange rates, and relative costs of living and housing between countries, and it must have a systematic program for applying such data when posting and maintaining an executive abroad. However, it cannot escape managerial judgment, as there will always be situations which escape the logical patterns it has set up. ■

NOTE

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Five Scenarios For The Future Of World Trade

Time And The Manager: Allocating A Scarce Resource

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The Wharton Magazine Economic Newsletter

Econometric Forecast

For the United States, 1982.1—1983.4

Prepared by
Lawrence R. Klein, Donald Straszheim, Allen Gutheim, Edward A. Friedman, Stephen Able,
Edward Hill, Wayne Tarken, Ellis Tallman, and Gordon Bryant
Wharton Econometric Forecasting Associates

Conditions Are Dismal; Oil In Glut

The economic statistics released during January were almost universally unfavorable. Output was falling precipitously, and interest rates and the money supply were spiking upward, threatening even more damage to the already devastated real side of the economy.

February's numbers have been somewhat mixed, but the negatives definitely prevailed. Most measures of real economic activity continued to slide, but both inflation and interest rates started to look better.

The Reagan administration's fiscal 1983 budget has been released – and reacted to in various ways. In addition, Federal Reserve Board Chairman Paul Volcker has announced monetary targets for 1982.

Several questions are suggested by the new data and new policy information:

☐ How weak will the economy be in the first quarter, and will the second quarter still be a transition quarter to real growth?

☐ Does second-half growth still look plausible? If so, at what rate?

☐ Will the recent improvement in inflation be sustained?

☐ With interest rates and the money supply gyrating, what is the monetary policy-financial outlook?

☐ What is the meaning of continued $100 billion federal deficits?

☐ Could 1983 and 1984 be stronger, with less inflation and lower interest rates?

It is difficult to find economic activity statistics now that are even neutral, much less favorable. Industrial production fell a large 3.0% in January, the sixth straight month of decline at increasingly large rates. There are plenty of other negative economic data too monotonous to recite.

The revised real gross national product numbers for the fourth quarter of 1981 showed a 4.7% annual rate of decline instead of the earlier released 5.2%. None of the revisions were substantial enough to alter the fundamental picture.

The brightest spot in the economy is inflation. The consumer price index rose 0.3% in January, after similar small rises in November and December. On a year-ago basis the CPI has slowed to 8.4%, from a peak rise of 14.7% in early 1980, and all major categories have improved. Producer prices also have dramatically slowed their advance. The energy sector is especially encouraging, with the worldwide oil glut continuing to put downward price pressure on OPEC.

The most favorable anti-inflation developments have been in wages. Ford and the United Auto Workers Union reached agreement seven months before contract expiration. While wage-push inflation will continue, there is room for optimism.

Interest rates remain very volatile. Three-month Treasury bills rose from 10.23% at the end of November to 14.41% in mid-February, but have eased since. Corporate bond rates have also moved widely.

The money supply is still erratic. Over the last three months alone, the money supply has been both well above and well below its annual targets.

Policy is the main question. Fed Chairman Volcker recently said that 1982 monetary growth would be restrained to prevent refueling inflation, but implied that the Fed would be shooting for the top of the 2.5% to 5.5% M-1 growth band.

The Reagan administration's federal budget, showing a high but gradually declining deficit, has been greeted by a mixture of reactions, and considerable debate – and revision – is certain.

Our forecast shows real gross national product declining at a 4.4% annual rate in the first quarter of 1982, and a smaller negative, 0.6%, in the second quarter, when the bottom will have been reached. Even though the recent numbers have been dismal, there remain reasons to believe that growth will resume in the second half of 1982.

☐ The tax-cut stimulus is on the books, to be effective in mid-1982. Even small recoveries in automobiles and in housing will aid the recovery.

☐ The anticipated interest-rate decline will also help those credit-sensitive sectors.

☐ The inventory correction still has a way to go, but should be complete by mid-year.

☐ The recent decline in inflation helps real income, and should not be minimized in terms of its contribution to an upturn. It has been many years since such favorable price statistics confronted the con-

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sumer in the marketplace.

Inflation prospects are very heartening. Wages should continue to slow, energy risks look minimal, and weakness will be the rule in both labor and product markets. Year-end to year-end, the GNP deflator is forecast to rise 7.7% in 1982, down from 8.8% in 1981 and 9.8% in 1980.

Short-term interest rates should decline somewhat further during the middle quarters of 1982 before starting to rise when high public-sector and rising private-sector credit demands meet a reluctant Fed.

The year 1980 was marked by a short but sharp recession, and 1981-1982 has been marked by another one. With interest rates and inflation both much improved, the Wharton forecast shows real GNP growth of 3.9% in 1983 and 1984. This is substantial growth, but weak in historical context.

The keys to higher or lower growth are inflation and interest rates. If inflation continues to recede and interest rates fall, then a major, extended economic expansion could develop. Conversely, if prices should reaccelerate and interest rates do not fall very far, then there is little reason to believe that the economic expansion would be either very vibrant or long-lasting.

Industrial Activity: With a big 3% decline recorded in January, industrial production has fallen by progressively larger amounts for the last six consecutive months. Capacity utilization also fell in January (from 73.0% to 70.4%), and will pierce the low recorded in 1975 during the next two months.

Employment: Employment has fallen by more than 200,000 in each of the last four months, with much of the decline centered in durable-goods manufacturing. The weakness will infect the remainder of the economy in the coming months. The January unemployment rate decline from 8.8% in December is a one-month statistical aberration. Unemployment is expected to average near 9% during 1982.

Inflation: January was another month of improving inflation performance. The consumer price index rose 0.3% in January, and the producer price index 0.4%. The price slowdown has been widespread, not just centered in food, energy, or mortgage

Forecast: The Next Two Years

Selected Economic Indicators — March 3, 1982

Economic Activity and Income	1982.1	1982.2	1982.3	1982.4	1983.1	1983.2	1983.3	1983.4
Real Gross National Product $ (1972)	1480.9	1478.7	1490.5	1506.2	1523.8	1537.8	1555.0	1569.2
% change	−4.4	−0.6	3.3	4.3	4.7	3.8	4.5	3.7
Gross National Product $	3019.7	3071.8	3151.4	3243.1	3336.5	3425.4	3523.8	3621.3
% change	3.3	7.1	10.8	12.2	12.0	11.1	12.0	11.5
Industrial Production (1967 = 100)	141.4	140.6	141.3	144.3	147.5	149.5	152.0	153.8
% change	−12.8	−2.2	2.1	8.6	9.3	5.5	7.0	4.6
Unemployment Rate %	9.1	9.3	9.2	9.1	8.8	8.8	8.4	8.3
Personal Savings Rate %	5.1	5.5	6.6	6.6	6.4	6.1	6.9	6.4
Auto Sales (millions)	8.6	7.6	8.5	8.9	9.4	9.8	10.2	10.5
Housing Starts (millions)	0.89	1.06	1.12	1.20	1.28	1.36	1.41	1.52
Current Account Balance $	−1.3	−1.4	−0.4	−2.0	−3.1	−1.4	−2.6	−8.3
Real Disposable Income $ (1972)	1041.3	1043.7	1066.0	1073.5	1079.5	1085.1	1106.4	1110.5
% change	−2.3	0.9	8.9	2.8	2.2	2.1	8.1	1.5
Aftertax Corporate Profits $	134.9	134.8	142.9	150.5	148.4	157.6	168.7	175.4
% change from year ago	−20.3	−11.7	−8.6	6.8	10.0	16.9	18.0	16.5
Federal Surplus $	−109.0	−110.0	−144.6	−137.4	−111.1	−107.1	−137.3	−135.8
Components of Gross National Product								
Real Consumption Expenditures $ (1972)	962.3	959.7	969.5	976.4	984.0	991.9	1002.5	1011.4
% change	2.1	−1.1	4.1	2.9	3.1	3.3	4.3	3.6
Real Business Fixed Investment $ (1972)	157.6	155.4	153.6	154.1	155.8	157.4	160.3	162.7
% change	−9.7	−5.5	−4.8	1.5	4.3	4.3	7.5	6.2
Real Government Purchases $ (1972)	292.9	289.9	290.2	291.0	291.9	293.0	293.6	293.8
% change	−3.6	−4.0	0.4	1.1	1.3	1.5	0.9	0.2
Net Exports $ (1972)	34.5	31.8	32.0	32.1	32.9	34.1	34.9	35.4
Inflation and Determinants								
GNP Deflator (1972 = 100)	203.9	207.7	211.4	215.3	219.0	222.7	226.6	230.8
% change	8.0	7.7	7.3	7.6	6.9	7.1	7.1	7.5
Consumer Price Index, % change	5.7	5.4	6.1	5.5	6.9	7.2	6.5	6.6
Producer Prices, % change	5.2	6.3	7.3	7.0	6.3	5.9	6.2	6.6
Average Hourly Earnings, % change	8.3	8.1	7.2	7.3	8.5	7.4	7.0	6.6
Financial Markets								
Federal Funds Rate %	13.9	14.0	12.7	13.5	13.7	14.0	14.8	14.5
3-Month Treasury Bill Rate %	12.6	12.3	12.1	13.7	14.0	14.0	14.1	13.7
Moody's Seasoned AAA Bond Rate %	16.2	15.7	15.5	15.7	15.2	14.6	14.1	13.5

[$ amounts in billions. All $ figures are current dollars except those marked $ (1972)]

interest costs. Attention during the rest of the year will focus on wages.

Housing: Starts in January (894,000) were under one million for the sixth consecutive month. Existing home sales in January fell to their lowest level since these data were first recorded in 1966. With mortgage rates over 17% and with the savings and loan industry in dire straits, there is little reason to expect more than a tepid housing advance across 1982.

Nonresidential Fixed Investment: There is some chance that the new equipment-leasing provision in the Economic Recovery Tax Act of 1981 may be reduced. This would not be good news for the equipment producers, which are already in poor shape because of the recession. Nonresidential building is still fairly strong, but won't stay that way for long.

Inventories: Inventories fell in December for the first time since 1975. The overhang is modest, however, and accumulation should resume in the second half. The inventory-to-sales ratio stabilized at a 1.49 monthly rate in December, indicating that production declines are catching up with the falloff in final demand.

Corporate Profits: Real output is down sharply, utilization rates are low and falling, and payrolls are being reduced, all in the name of reducing the flow of red ink. Various surveys show conclusively that profits fell sharply in the fourth quarter of 1981, and another major decline in the first quarter of 1982 is a certainty.

Government Outlays: The new Reagan administration budget has stirred up a real debate. Many programs already were chopped severely in 1981, and defense spending is certain to be strong. In order to fight the deficit, many tax and spending ideas are being considered.

Money and Credit: Interest rates turned the corner in mid-February, and monetary growth appears to be headed back towards the 1982 Fed target growth range. Rates will fall somewhat further before rising private- and public-sector credit demands begin to clash later in the year. Compared to past recoveries, interest rates will stay very high throughout the next several years. ■

1981	1982	1983	1984
1510.0	1489.1	1546.5	1606.6
2.0	−1.4	3.9	3.9
2924.8	3121.5	3476.8	3852.5
11.4	6.7	11.4	10.8
150.9	141.9	150.7	159.0
2.6	−6.0	6.2	5.5
7.6	9.2	8.6	7.7
5.3	5.9	6.4	5.6
8.6	8.4	10.0	10.7
1.10	1.07	1.39	1.68
6.2	−1.3	−3.9	−8.7
1040.2	1056.1	1095.4	1121.9
2.1	1.5	3.7	2.4
154.8	140.8	162.5	182.1
−5.1	−9.1	15.4	12.1
−62.0	−125.3	−122.8	−125.4
958.8	967.0	997.5	1028.8
2.5	0.8	3.2	3.1
162.2	155.2	159.0	169.0
2.4	−4.3	2.5	6.3
291.7	291.0	293.1	294.8
0.6	−0.3	0.7	0.6
44.4	32.6	34.3	40.1
193.7	209.6	224.8	239.7
9.2	8.2	7.2	6.7
10.3	6.9	6.4	5.8
9.3	5.8	6.5	7.0
9.7	8.3	7.6	6.8
16.4	13.5	14.2	12.1
14.0	12.6	14.0	12.0
15.1	15.8	14.4	12.5

Collective Bargaining In 1982

By Stephen L. Able

Every third year in the United States brings an especially large number of collective bargaining agreements up for negotiation. This is just such a heavy bargaining year.

Many of the large "target setting" agreements are centered in major industries that are suffering from severely depressed economic conditions. Accordingly, virtually all observers expect union wage demands to be moderate, and this assumption is incorporated into recent Wharton forecasts. There is a strong possibility that wage settlements will be appreciably lower than in the recent past. If they are, it will produce consequences reaching far beyond the companies and unions that are parties to the negotiations.

Bargaining during 1982 will take place within a much different economic environment than in any recent year.

The unemployment rate has risen substantially over the last two years; at year-end 1981, it stood at 8.9%. By sharp contrast, in the last two major bargaining years, 1976 and 1979, the unemployment rate was both lower and declining.

Inflation as measured by the consumer price index has slowed markedly over the past year. Food and energy prices, two of the most visible in the consumer marketplace, have been stable or declining recently, contributing to lower perceptions of inflation than even the moderate CPI numbers suggest. Therefore, unlike the 1979 experience, CPI changes should not exert upward pressure on union wages through large cost of living adjustments in 1982.

Hard evidence exists that wage moderation will prove to be the norm in the unionized sector of the economy. Negotiations already have been concluded in some industries, including the very important trucking industry. The settlements have been substantially lower than those in recent prior contracts. Also, a large number of unions, including the powerful United Auto Workers, have reopened previously concluded negotiations (or opened negotiations for new contracts well ahead of schedule) in order to grant wage and work-rule concessions to hard-pressed employers. A trend toward moderate wage settlements thus appears to be under way.

Some Recent Settlements

Airlines: During 1981, six major commercial airlines reopened bargaining in mid-contract and obtained either wage and benefit cuts, wage freezes, or more productive work rules.

Meatpacking: The United Food and Commercial Workers Union agreed in December 1981, eight months before the expiration of the existing contract, to a new 44-month pact with Armour, Wilson, and several Hormel plants. Except for a 75-cent cost of living adjustment due under the previous agreement, the current contract calls for no wage increase until at least September 1984, when wage negoti-

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ations may be reopened.

Union wage settlements are strongly influenced by the key trucking and auto industry settlements. The average growth rate of wages in the trucking industry rose from 9.5% during the 1976-1978 period to 10.5% during the 1979-1981 period. Auto wage rates increased from 10.8% to 12.3% over the same period. The 8% and 9.5% growth rates for the unionized sector as a whole over the same periods were lower; the degree of wage acceleration between the former period and the latter was, however, quite similar for the average of the two key industries and the overall unionized sector.

Changes in union wages, nonunion wages, and price inflation are also closely related. Any deceleration in union wages during 1982 is likely to be followed almost immediately by deceleration in the growth rates of economy-wide wages and prices.

The Wharton forecast for wage and price inflation during 1982 is consistent with this scenario: Moderate wage settlements in the major "target" industries, deceleration in wage growth throughout the economy, and continued improvements in inflation.

However, autos and trucking are hard-pressed industries, and unions in stronger industries are unlikely to agree to the same degree of concessions as the UAW and the Teamsters. While accelerations and decelerations of wages in these "target" industries are generally followed by accelerations or decelerations of other union wage agreements, the magnitudes are often different. Therefore, while wage gains will likely slow throughout the unionized sector, the overall slowdown will be less dramatic than in autos and trucking.

Does the 1982 bargaining round signal an end to unreopenable three-year contracts? Such contracts have been the rule since 1948, when General Motors and the UAW first signed one. Not until 1981 did unions consider reopening significant contracts when they could only lose hard-won wages and benefits. It is too early to say whether the recently reopened contracts are the start of a permanent shift toward shorter contract lives, or just a temporary aberration.

Less uncertainty surrounds a shift in union emphasis toward job security. Unions have never been overly concerned about this issue, because they have not faced severe industry-specific slumps of the current magnitude since the Depression. Union leaders and rank-and-file workers alike are becoming increasingly cognizant of the trade-off between wage gains and job security.

Capacity Utilization Rates: United States

By Allen Gutheim

Capacity utilization in the three major sectors has fallen during the past several years. Utilization of plant and equipment peaked in 1979 in the manufacturing sector, and in 1978 in both the mining and utility sectors. Sluggish real economic growth since those years has ensured continued drops in utilization.

In the manufacturing sector, quarterly changes in utilization have been substantial. To a fair extent, this is related to changes in automobile output.

Ongoing low levels of capacity utilization during 1981 have undoubtedly continued into 1982. The failure of the administration's business tax changes to initiate any plant and equipment investment is undoubtedly related to this fact. With plenty of excess capacity available in most industries, and sluggish economic growth expected, few businessmen are prepared to expand their capital budgets. We do not expect any real recovery in capital spending until the capacity utilization index returns to the 89-90 level.

United States: 3rd Quarter, 1981

Year	Manufacturing	Mining	Utilities	M.M.U.[1]
1981.3	86.5%	77.3%	85.5%	85.9%
1981.2	86.6	73.0	85.4	85.7
1981.1	87.1	78.4	85.0	86.5
1980.4	86.1	75.3	84.8	85.3
1980.3	82.5	73.5	86.6	88.1
1980	85.8	76.1	85.7	85.2
1979	91.7	76.9	87.4	90.5

[1]M.M.U. = Mining, Manufacturing, and Utilities.

Foreign

By John Savacool

The beginning of the current recession is clearly visible in the indices of foreign capacity utilization for 1981. Canada was the only major country which experienced an increase in the capacity utilization rate during the second quarter of 1981. The utilization rates in France, West Germany, Japan, and the United Kingdom all declined slightly during the second quarter of 1981, while the Italian capacity utilization rate fell from 90.2% in the first quarter to 86.5% in the second quarter, the largest decline among our major trading partners.

Looking back to 1980, we see that only Italy and Japan posted increases over 1979. The French economy has not experienced an increase in its utilization rate since the third quarter of 1979, but the recent data on French industrial production indicate that the fourth quarter of 1981 may show an increase over the third quarter.

Foreign: 3rd Quarter, 1981

Year	Belgium	France	Germany	Italy	Holland	U.K.	(Average)[2]	Canada	Japan
1981.3	73.3%	—%	—%	—%	—%	72.8%	—%	—%	81.4%
1981.2	73.9	71.3	80.3	86.5	—	72.7	—	87.2	80.6
1981.1	75.6	71.4	81.2	90.2	71.4	72.8	78.3	85.4	81.9
1980.4	73.1	73.9	80.2	89.8	75.3	78.2	79.5	84.8	81.6
1980	79.0	76.5	83.5	91.1	74.6	79.5	81.9	84.7	82.4
1979	83.7	81.3	86.7	89.1	77.8	86.9	85.6	89.0	80.2
1978	81.6	80.1	85.1	86.3	78.3	87.8	84.4	88.3	77.9

[2]The average of the first six countries on this table.

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The Wharton Magazine Economic Newsletter

Econometric Forecast

For the United States, 1982.2—1984.1

Prepared by
Lawrence R. Klein, Donald Straszheim, Allen Gutheim, Edward A. Friedman, Stephen Able, John Savacool, Edward Hill, Wayne Tarken, Ellis Tallman, Gordon Bryant, and Janice Westfall
Wharton Econometric Forecasting Associates

Consumers May Lead A Recovery

Interest rates remain at killing levels. On the fiscal front, controversy and confusion reign, and there is little enthusiasm for deficits in excess of $100 billion – which seem certain for the next several years. With business weak and interest rates high, profits are down sharply.

Despite all this, the second quarter is still expected to mark the end of the recession. The upturn depends entirely on the inventory component of output. Not until the third quarter, with the stimulus of the individual income tax cut, will real final sales turn meaningfully positive.

Our forecast shows growth resuming in the second quarter at a modest 2.0 percent annual rate. Inventory decumulation at a $6.9 billion annual rate is forecast for the second quarter (in constant 1972 dollars), compared with the revised $17.2 billion decline recorded in the first quarter. This $10.3 billion difference – a smaller negative this quarter than last – serves to raise the level of output in the National Income Accounts.

While the net effect of the inventory swing is positive, it is important to note that inventories are still being drawn down in the quarter, and the swing to a smaller rate of decumulation is a rather weak positive element. The inventory turnaround is larger than the entire swing in real output. Real final sales are actually forecast to decline in the second quarter – by $2.9 billion.

Most industry observers now believe that inventories are so lean throughout the economy that further liquidation on the scale of that recorded in the first quarter of 1982 is impossible: inventory behavior has been cautious as the economy has stumbled for more than two years; excess inventories are still very expensive to carry at today's interest rates; and prices are not rising as they did in the past, further dampening the appetite for carrying inventories.

Consumer spending is the major element in the economic recovery during the second half of 1982.

Two major positives are coming July 1: the 10 percent individual income tax cut and the annual cost-of-living rise in Social Security benefits. A third installment of the tax cut is also on the books for July 1983. Despite the serious recession, the financial condition of consumers has been improving. The use of consumer credit is down considerably. Any reduction in interest rates or improvement in overall economic conditions would allow a substantial gain in consumer credit use. In addition to the tax cut, lower inflation is an important positive.

Our forecast shows real consumption and real disposable income advancing in the remainder of 1982 and into 1983 and 1984.

The first quarter of the year was a bad one for profits. After-tax corporate profits fell from an annual rate of $144.0 billion in the final quarter of 1981 to $118.8 billion in the first quarter of 1982.

The decline in profits is no mystery: demand has been devastated, plant utilization has been low, prices have been weak, and inventory carrying costs have remained high.

Our forecast of a modest economic recovery commencing in the second quarter of 1982 is bullish for profits. While profits will likely still fall in the second quarter, they will begin to advance in the third quarter as demand and prices firm, capacity utilization increases, and labor productivity picks up.

The best of the short-run inflation statistics are now history – which is no surprise, because they were clearly unsustainable. The consumer price index for urban workers rose by 0.2 percent in April, after having fallen 0.2 percent in March. Producer prices also turned around in April, rising 0.1 percent after a 0.1 percent March decline.

The extraordinarily good inflation performance cannot continue. Energy prices in spot markets – and in some wholesale and retail markets as well – have already begun to firm. Prices of many sensitive commodities appear to have bottomed out, and others will start to move upward as the economy recovers.

This is not to suggest that a return to double-digit inflation is imminent. Quite to the contrary, the inflation improvement has been widespread and is very real. Our forecast has the CPI rising at a 1.1 percent annual rate in the second quarter and the GNP deflator rising at a 6.1 percent annual rate. In the following year, both the CPI and the GNP deflator are expected to remain in the 5.0 percent to 7.0

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percent range.

The path of the monetary aggregates and the Federal Reserve's policy stance remain central to the outlook.

In late 1981 the Federal Reserve announced M-1 targets of 2.5 percent to 5.5 percent growth for the fourth-quarter 1981 to fourth-quarter 1982 period. Approximately one-half year has elapsed, with money growth consistently above the top of the target band. Virtually all of the overage stemmed from the first few weeks of 1982.

Looking beyond the money aggregates, we see real interest rates remaining at extraordinarily high levels. Economic activity in the credit-sensitive sectors – a measure of the toll that tightness exacts – should remain weak.

Our forecast assumes that money growth will remain somewhat above the high end of the targets, but not so much that it precipitates a major new restrictive reaction by the Federal Reserve and a major run-up in interest rates.

Despite a substantial money-supply bulge in April, interest rates did not spiral upward. Even with the economy recovering, the renewed late-1982 rise in interest rates anticipated in our forecast is modest. In 1983, as inflation settles down some more, a further edging down of interest rates is expected.

Employment: The unemployment rate rose from 9.0 percent in March to 9.4 percent in April, the highest rate in over forty years. Employment, as measured both by the "household" survey and by the "establishment" survey, was down as well. The unemployment rate statistic needs careful interpretation at this time of the year – seasonal adjustment is a difficult proposition when many are leaving school and entering the labor force during the summer months.

Income: Personal income rose by 0.3 percent in April. Gains in transfer payments and interest income more than offset a decline in wage and salary income. The income outlook is improving, thanks to good price news and the coming tax cut.

Non-residential Fixed Investment: Business fixed investment declined again in the first quarter of 1982, and three more negatives are now expected to follow. There is little reason for optimism here:

Forecast: The Next Two Years

Selected Economic Indicators — June 3, 1982

Economic Activity and Income	**1982.2**	**1982.3**	**1982.4**	**1983.1**	**1983.2**	**1983.3**	**1983.4**	**1984.1**
Real Gross National Product $ (1972)	1489.6	1506.5	1518.0	1529.4	1545.7	1565.4	1581.0	1594.1
% change	2.0	4.6	3.1	3.0	4.3	5.2	4.0	3.4
Gross National Product $	3051.5	3132.1	3209.7	3279.2	3362.1	3452.6	3542.8	3626.9
% change	8.2	11.0	10.3	8.9	10.5	11.2	10.9	9.8
Industrial Production (1967 = 100)	141.1	142.8	144.6	145.6	148.1	151.3	153.5	155.6
% change	−1.5	5.0	5.0	2.9	6.9	9.0	6.1	5.4
Unemployment Rate %	9.6	9.4	9.2	9.1	8.9	8.8	8.6	8.7
Personal Savings Rate %	6.0	7.5	7.3	7.0	7.0	8.1	7.8	7.3
Auto Sales (millions)	7.9	8.6	9.2	9.6	9.9	10.5	11.0	10.9
Housing Starts (millions)	0.96	1.04	1.14	1.24	1.30	1.39	1.49	1.56
Current Account Balance $	2.3	−3.7	−9.4	−11.6	−5.8	−3.2	−11.2	−16.1
Real Disposable Income $ (1972)	1053.8	1081.7	1088.8	1094.9	1104.7	1131.1	1139.7	1139.8
% change	2.3	11.0	2.6	2.3	3.6	9.9	3.1	0.1
Aftertax Corporate Profits $	117.5	129.2	139.6	132.0	143.6	159.5	169.3	178.7
% change from year ago	−23.0	−17.3	−3.0	11.1	22.2	23.4	21.2	35.4
Federal Surplus $	−130.0	−165.6	−157.0	−140.1	−135.1	−159.6	−161.9	−148.9
Components of Gross National Product								
Real Consumption Expenditures $ (1972)	964.4	973.8	983.2	991.6	1000.2	1011.9	1022.4	1027.0
% change	0.0	4.0	3.9	3.5	3.5	4.8	4.2	1.8
Real Business Fixed Investment $ (1972)	161.2	159.7	159.0	159.6	161.4	164.0	167.4	171.4
% change	−2.9	−3.8	−1.6	1.4	4.7	6.4	8.6	9.9
Real Government Purchases $ (1972)	291.6	292.6	291.0	291.8	293.0	293.9	294.6	296.3
% change	−5.1	1.4	−2.1	1.1	1.7	1.2	1.0	2.2
Net Exports $ (1972)	39.5	37.5	34.8	33.3	33.0	32.1	30.1	30.5
Inflation and Determinants								
GNP Deflator (1972 = 100)	204.8	207.9	211.5	214.4	217.5	220.6	224.1	227.5
% change	6.1	6.1	7.0	5.7	5.9	5.7	6.6	6.3
Consumer Price Index, % change	1.0	6.0	6.4	5.4	4.7	4.8	6.1	6.8
Producer Prices, % change	−0.1	6.2	6.8	6.9	6.6	6.8	7.1	7.1
Average Hourly Earnings, % change	7.0	6.6	6.3	7.1	6.3	6.0	6.2	6.2
Financial Markets								
Federal Funds Rate %	14.0	13.4	14.3	14.6	13.9	13.1	12.8	12.2
3-Month Treasury Bill Rate %	12.4	12.0	12.5	12.7	12.4	12.0	11.8	11.3
Moody's Seasoned AAA Bond Rate %	14.6	14.3	14.1	14.0	13.9	13.4	13.2	12.7

[$ amounts in billions. All $ figures are current dollars except those marked $ (1972)]

capacity is excessive, prices are weak, capital costs are still high, and the recovery promises to be slow.

Inventories: The turnaround in the economy during the second quarter centers on business inventory behavior. This is, as always, a tricky matter to call – and the current circumstance is no exception.

Inflation: Most of the good news is centered here. The year-over-year consumer price index inflation rate has dropped to 6.6 percent – the lowest since February 1978. On the same basis, the producer price index is up just 3.2 percent, the lowest since November 1976. However, the beneficial effects of declining energy prices are now over.

Corporate Profits: Corporate profits after taxes fell at a 53.7 percent seasonally adjusted annual rate in the first quarter. Not unexpectedly, many companies are in severe difficulty – as the bankruptcy statistics reveal. The second quarter will record another drop in profits, but the outlook thereafter is improved.

Foreign Account: The U.S. trade position will remain difficult for some time. High interest rates and the attendant upward pressure on the dollar are yielding a more difficult competitive situation for U.S. exporters. Similarly, weak foreign currencies make imports more price competitive. The expected recovery will further enlarge the U.S. appetite for imports.

Government: Fiscal policy remains a tangle. The hoped-for budget compromise in April fell through. The budget debate, already hot, will not be resolved quickly. Funding government activities on a "continuing resolution" basis for the indefinite future is a possibility. The federal deficit, in excess of $100 billion, is going to be large by anyone's measure, regardless of the policy choices made in Washington in the near future.

Money and Credit: A few well-known bankruptcies reveal the severity of the current squeeze. Interest rates remain high, as the Federal Reserve attempts to lower the demand pressure on inflation. Long-term rates are still too steep for many borrowers to deal with, causing increased congestion in the short-term markets. The Fed's position is clear: a reversal in monetary policy is not in the cards. ■

1981	1982	1983	1984
1510.2	1499.1	1555.4	1611.8
2.0	−0.7	3.8	3.6
2925.5	3096.2	3409.2	3761.0
11.4	5.8	10.1	10.3
150.9	142.5	149.6	158.2
2.6	−5.5	5.0	5.7
7.6	9.2	8.8	8.5
5.3	6.6	7.5	6.9
8.6	8.5	10.3	11.1
1.10	1.01	1.35	1.65
6.6	−2.9	−7.9	−22.1
1040.4	1068.0	1117.6	1142.8
2.2	2.7	4.6	2.3
155.6	126.3	151.1	188.1
−4.7	−18.8	19.6	24.5
−62.4	−144.7	−149.2	−143.8
958.9	971.5	1006.5	1034.2
2.5	1.3	3.6	2.8
162.4	160.6	163.1	176.7
2.5	−1.1	1.6	8.3
291.7	292.7	293.3	296.2
0.6	0.3	0.2	1.0
44.9	37.5	32.1	32.2
193.7	206.5	219.1	233.3
9.2	6.6	6.1	6.5
10.3	5.5	5.2	6.5
9.3	3.8	6.3	7.2
9.9	9.0	6.5	6.1
16.4	14.0	13.6	12.0
14.0	12.4	12.2	11.0
14.2	14.5	13.6	12.5

Federalism: Who Should Do What?

By Nariman Behravesh

The debate over the distribution of public responsibilities among federal, state, and local governments has been going on since the early days of the Republic. In the fiscal system that has evolved, the federal government has played a dominant role because of its defense, stabilization, and income-security functions. Education and transportation have been important responsibilities of state and local governments.

As the provision of services has changed among the three levels of government over time, a mechanism of inter-governmental funds transfers has evolved, and come to be dominated by a complex system of grants. In the past decade, a number of attempts have been made to simplify the structure of grants from the federal to the state and local governments. Efforts have been made to allow state and local governments more freedom to spend federal funds as they see fit.

More recently, fiscal-federalism discussions have focused on the efficient assignment of responsibilities among the levels of government – and the corresponding distribution of revenue sources. These discussions have resulted in a number of "new federalism" proposals, most notably from the Reagan administration.

These proposals generally address the relationships between federal and state governments and recommend swaps of programs, such as Medicaid for food stamps and Aid to Families with Dependent Children. The measures also propose turn-backs of other grant-financed programs to states, with a corresponding turnover of revenues – specifically excise taxes.

Guiding Principles

Several principles have guided the discussion on how to restructure the present system of federalism. On the expenditure side, there is general agreement that:

☐ the provision of public services should be by the jurisdiction within which the benefits accrue, and

☐ concern with distributional adjustments, especially with regard to income, should be federal.

The guiding principles in determining whether a particular tax is appropriate to a particular jurisdiction are that:

☐ the burdens should be borne within the jurisdiction, and

☐ distorting effects on location should be minimized.

On the basis of these principles, many groups have argued that the programs with the greatest national purpose – including such income-maintenance programs as AFDC, Medicaid, and food stamps – should be nationalized. Other programs with more local purpose – such as education, community development, intrastate highways, and law enforcement – should be devolved to the lower levels of government. Programs with a shared interest should be centralized, but funded with block grants in an attempt to simplify their

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administration. This category of programs would include interstate highways and pollution abatement.

The rationale for this approach is that it would assure more uniform benefit standards and more equitable financing of welfare-type programs. It would also allow greater discretion and possible variation in areas of state and local responsibility. Another advantage might be that it would remove from states the burden of added program costs during economic downturns, since income-maintenance programs are the most cyclically sensitive. State governments could then channel their resources into other areas, such as urban redevelopment.

Other groups oppose this view of federalism, for a number of reasons. The Reagan administration has rejected it because it would centralize welfare policy in Washington. Moreover, the total costs of the income-maintenance programs might rise because of the leveling-up of benefits across states. Federalizing AFDC and Medicaid would also likely diminish the cost-control efforts that many states have been pursuing. Finally, as in any restructuring of the present system, some states would gain and others would lose.

Time of Transition

Returning the responsibility for providing certain public services to state and local governments would reduce federal intervention in their affairs. But if states and localities did not pick up the taxing sources, the result might be resources that are inadequate to meet those responsibilities.

In fact, a rethinking of this matter is one of the possible outgrowths of the current national debate. The states and localities may choose not to fund certain programs that had been funded through federal taxes – they could instead choose to reduce public services.

In this transition, two matters of general interest arise that are related to the adequacy of state and local resources. The first is eliminating or reducing certain federal taxes, so that other governments could pick them up if they chose. This approach would provide maximum flexibility for states and localities in determining the appropriate level of services and the best method of financing. It would also ensure that the government with the spending authority bears the political costs of raising the necessary revenues. The problem with this approach is that it does not address differences in the fiscal capacities of state and local governments. In fact, given the existing uneven distribution of certain revenue sources among states, the approach could increase, rather than diminish, fiscal disparities.

The second major issue involves the regional disparities that would result from a turn-back of federal taxes through expanded revenue-sharing. Such a turn-back would allocate most funds to those jurisdictions with the fewest resources of their own – helping to minimize the distortions due to locational differences in taxation. Furthermore, revenue-sharing would permit the federal government to maintain some leverage over the activities of other levels of government. On the other hand, this approach would weaken the link between taxing and spending responsibilities.

Major "new federalism" proposals address many of these issues. President Reagan's federalism initiatives, outlined and delivered to the Congress on January 27, 1982, have received the most attention. The main elements of this plan are:

- ☐ a swap, whereby the federal government would assume full responsibility for the Medicaid program and the state governments would take the food-stamp and AFDC programs;
- ☐ the turn-back of 43 federal categorical- and block-grant programs to the states, including community development, transportation, education, social, health, and nutrition programs;
- ☐ the establishment of a trust fund totaling $28 billion, originally financed by excise taxes on gasoline, tobacco, alcohol, and telephone service, and by part of the oil "windfall profits" tax; and
- ☐ the phasing-out of the above-mentioned trust fund between 1987 and 1991, with states taking over many of the taxes.

Estimates Differ

By the administration's estimates, the takeover of Medicaid and the establishment of the trust fund would more than offset the cost to the states of taking on AFDC, food stamps, and the 43 federal grant programs. The White House estimates that states will end up with a surplus of $4.6 billion by 1987 as a result of the New Federalism.

The White House's estimates of the cost of the president's federalism initiative have been challenged.

Critics assert that the White House has understated the cost of the AFDC, food-stamp, and federal aid programs by assuming that additional cuts would be made before they are turned over to the states, and has made few allowances for inflation. These assumptions alone, they claim, lowered the estimated costs to the states by $15 billion to $20 billion in 1987.

The administration's budget document indicates plans to cut the Medicaid program after 1984; however, these cuts are not reflected in the cost estimates.

Some observers have noted that the White House estimates for "windfall profits" tax receipts may be too high, by as much as $8 billion for 1987.

If these criticisms turn out to be valid, then the projected $4.6 billion state surplus in 1987 could easily turn into a very large deficit.

Recent estimates by the Congressional Budget Office show that the net cost of the president's "new federalism" proposals will be about $43 billion in 1984, and that the trust fund will generate $32 billion in that year, yielding an $11 billion net cost to the states. Under these CBO estimates, the net cost is expected to grow substantially over time.

Many observers outside the administration believe that the president's program takes a very moderate view of the cost that would be borne by states, and also that it does not provide for adequate sources of turn-back funds, especially in later years.

The major accomplishment of the president's initiative has been to start the national debate. The president's plan, as set forth in late January, was billed as "a framework for discussion, with details to be filled in following intensive consultation...."

That process has commenced. One of the outgrowths has been, as with any proposal, to shift the debate from the general to the specific. To date, the focus has been on how the fiscal responsibilities of the three levels of government should be realigned. ■